1940

Economic Conditions
Governmental Finance
United States Securities

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General Business Conditions

THE country has passed through a Presidential election which was strenuously and earnestly contested, and in which the "issues" (including all questions, policies, events and conditions which may have influenced voters) were so numerous and varied that on any single issue the significance of the vote can be hardly more than a matter of opinion. Doubtless the war was the most direct and immediate influence. On domestic issues no mandate can be said to have been given for any new policy, or against any old one. Both candidates and parties agreed upon the need for the most vigorous armament program of which the country is capable, and this program is overwhelmingly the chief influence on business.

It is regrettable, however, that the campaign produced little debate upon the fiscal and economic policies to be followed as the defense expenditures proceed. These policies are still forming, and they become of more pressing importance as business expands under the spending. During the past two months the volume of industrial production has risen to the highest level in the history of the country, but the output has not kept pace with orders. In lines affected by the defense program manufacturers are working against backlogs running from months to a year or more ahead. Defense contract awards still run heavy, and in the first half of November exceeded the October rate. More industries are approaching their immediate capacity than in many years. Those which are in this position can improve operating methods, resort to subcontracting, and make other adjustments, but can make major increases in production only as they get new machinery, train new labor, and in some cases build new plants.

This is the kind of situation in which buyers become concerned as to deliveries or priorities, and fearful of cost and price advances. They experience improvement in their own business, and need more materials and goods in process and in stock; and they build up inventories and lengthen commitments accordingly. The policy is rational, if not pushed to extremes. However, the susceptibility to suggestions of impending inflation spreads under such conditions. Business has been in this atmosphere of great activity during a good part of the Fall, with at least temporary sellers' markets in many lines, and prices held in check largely by sellers' restraint.

The Talk of Inflation

The country dreads an inflationary price movement, and there is no sound reason why such a movement should develop, in view of the abundance of raw materials, the idle labor and capital, and the technical resources that can be drawn on to increase production. It is the reasoned judgment of authorities in the peacetime industries that they can supply prospective demands, provided they are spaced according to actual needs and not swollen by hoarding. Where priorities for the armament industries are necessary, as in machine tools and possibly later in some other lines, they will undoubtedly be accepted as preferable to the inflationary alternatives, and in fact are unlikely to be gravely burdensome.

Buying of some raw materials and manufactured goods this Fall, particularly in the metal products, has exceeded any previous volume on record. In the aggregate, however, the buying is not to be considered a measure of actual consumptive demand, for it has plainly exceeded current requirements, and will be followed by increases in inventory as deliveries are made against the commitments. Thus there is a greater margin of safety against a general bottleneck condition than may seem to be the case. But there are specific bottlenecks, and there is danger of an inflationary state of mind. The tendencies since last Summer give warning of the latent danger of overbuying, which would end in business recession, but meantime would contribute to inflationary trends. To avert this danger requires not only cooperation and self-restraint among all elements of the population, but also sound public policies adopted with the threat in mind.

Importance of Public Policies

For all these reasons, the decisions which the Administration must make upon fiscal and economic policies, as the issues raised by the defense expenditures come to a head, are now the principal uncertainties in business calculations. The chief fiscal questions are whether taxes should be increased again and if so where they should be levied; how greatly non-defense spending can be cut; and to what extent borrowing will be supplied by the subscriptions of individuals and institutions out of their current savings or by an expansion of bank credit. These decisions will affect the volume of purchasing power for consumers' goods, and they are likely to influence market and business sentiment profoundly.

With respect to industry and trade, the argument against further tax increases is that they will unnecessarily depress peacetime business, without contributing to armament, since peacetime machinery is not readily convertible to armament production. The argument for tax increases, on the other hand, is that repression of peacetime buying is precisely what is needed to carry out the armament program without inflation. These views are based upon opposite premises, and it should be possible in due course to establish the facts. The reasons for delaying action until the effects of this year's tax increases are apparent are set forth in an article following, on "The Fiscal Program".

The chief economic question is how effectively public policies will encourage production, by efficient procurement and by reasonable policies affecting prices, labor, and industrial finance and taxation.

Public policies upon all these questions will determine to a considerable extent not only the effects of the defense program on business, but the success of the program itself. Since the election the chief influences in the markets have been developments which seemed to give indications as to the Administration's vews. Both stocks and commodities advanced temporarily upon Secretary Morgenthau's statement that he would seek an increase in the debt limit to sixty or sixty-five billion dollars, which was construed as an indication of inflationary trends.

In two other respects, however, Administration announcements have pointed toward policies to restrain inflationary tendencies. First, President Roosevelt stated that all public works expenditures, except those directly connected with munitions production, would be cut to the bone. Second, in certain commodity markets measures were set in motion to increase supplies, and thus avert further advances in domestic prices without enforcing actual controls.

Assuring Adequate Commodity Supplies

Three of these measures applied to the wool market, in which a squeeze has been operating. Army orders for woolen goods, required by regulation to be made from domestic wool, caused fine domestic wools to advance from 88 cents in August to $1.09, considerably above prices of foreign wools. These regulations have now been relaxed, permitting the use of foreign wool in Army cloth. Furthermore, specifications for the last lot of goods to be purchased under the 1940-41 fiscal year's program permit deliveries to run into August, so that new clip domestic as well as foreign wool can be used. Finally, Mr. Jesse Jones has announced that American shipping will be used as necessary to bring Australian wool to this country for the 250,000,000 pounds reserve to be accumulated in American ports. This wool will remain in bond, under British ownership, but will be on hand for sale to American mills if needed.

According to trade reports, not yet officially confirmed, a decision has been made as to copper which also signifies a policy of keeping supplies abundant and prices down. The mine producers' copper price is now 12 cents, and in the opinion of the Defense Commission's statisticians production at the 12 cent level may fall short of copper requirements in 1941 by an estimated 120,000 tons. However, between the alternative of allowing the price to rise to a point which would permit high-cost domestic producers to operate, or admitting copper produced by the American companies in South America, which is now available at 10 to 11 cents, the Administration is reported to have decided upon the latter course. The 4 cent excise tax on foreign copper would be an obstacle to private purchases of foreign metal, but the Government can pay the tax to itself, buy copper if it is needed, and make a profit on resales to domestic fabricators, if present price relationships hold.

These indications of policy may prove significant. Commodity markets quieted down after the post-election strength, and these developments were probably a factor, although a more basic reason is that many buyers have now gone as far as they care to in covering ahead, and are pausing for a time.

Costs and Wages

In previous issues of this Letter we have given figures which support the opinion that the supply of industrial raw materials will be generally adequate. The surplus of foodstuffs is common knowledge. These supplies are the best assurance against inflation originating in the staple commodities. To be sure, there have been some marked advances, as in lumber, which has forced building costs up. However, this country is able to produce all the lumber needed. The sharp price rise was due largely

to the bunching of orders for cantonments and other defense construction; and according to Mr. Stettinius of the Defense Advisory Commission these orders will not be as large in 1941 as they have been in 1940. Thus there will be leeway to allow for a probable increase in other requirements, and production is expected to rise.

In general, the danger point with respect to inflationary trends is not in the basic commodities, but in possible price increases at bottlenecks where the supply of manufactured goods is short, or in rising wages and wage costs. Demands for higher wages are on the increase and the trend of hourly rates is upward, although the rise so far has been slight. In most business upswings support for wage demands is usually found in a rising cost of living, but so far in this war the cost of living has not advanced appreciably. Food is abundant and cheap, depressed real estate conditions keep rents down, and any tendency toward higher costs in manufacturing has been absorbed thus far in the increased volume of production.

The "Monthly Survey of Business" of the American Federation of Labor, published during the past month, contains a great deal of material to support arguments for higher wage rates, and publishes a lengthy list of increases recently obtained by affiliated unions. It states that "constructive cooperation in defense activities is our duty and our opportunity," and that "companies able to pay higher wages sometimes use a wage increase as an excuse for unnecessary price increases. This is against the public good." Both of these statements are indicative of the Federation's sense of public responsibility, and the second shows that the writer is aware of the inflationary danger. However, there is no reference to the stability of living costs, or to the gains that labor is making through greater employment, longer hours and overtime rates, and consequent increases in weekly wages, of which the rise of 14 per cent in industrial payrolls between May and September, as reported by the Department of Labor, is evidence. As a basis for raising wage rates the Survey refers to "increased production and profits . . . Companies able because of higher earnings to pay a wage increase should do so."

Effects of Spreading Wage Rises

Taken all together, the statements carry no advocacy of higher wage rates where they would cause price increases, but it is pertinent to ask whether demands can in fact be confined to cases where the rise in costs can be absorbed entirely by the employer? The action of every union sets an example to others. Interchange of labor takes place among the industries and among companies in each industry, especially when demand for skilled labor is as strong as now. Thus wage rates are interdependent and what affects any important portion will spread to other parts. There is no record of experience to indicate that if wage demands spread they can fail to affect prices.

It is indisputable that labor should have a voice in determining its compensation, and wholly natural that it should take the view that a company making improved profits should raise wages. However, the policy has been established by the Government, and generally concurred in, that if profits rise unduly the excess will be heavily taxed, both to meet defense costs and to restrain inflationary influences. Over a period of eight years, 1930 to 1937 inclusive, the active corporations of the United States in the aggregate lost more than they earned; they are not only far behind their normal growth, but their capital is substantially smaller than in 1929; and it is in the interest of employes as well as employers that they have an opportunity to recoup. The situation after the boom should also be taken into account. Activity based upon armament expenditures financed by huge government deficits does not represent a sound or lasting prosperity, and when the expenditures cease the situation for the companies now making the best showing may be one of great difficulty. Exponents of wage increases based on improved profits should accept the converse view that when hard times come again and earnings are reduced labor should bear a part of the reduction; and it is a truism that downward wage adjustments are not as readily made.

The real issue, of course, is not whether labor or capital obtains an advantage over the other, but what is the interest of all. The gravest danger is that wage increases and consequent increases in production costs may lead to the rise in living costs which labor itself dreads. A rise in living costs would affect not only the workers who obtained the wage increases, but all groups of the population, including all other labor, farmers and salaried employes. These groups would either be put at a disadvantage with organized labor, or they would themselves be entitled to increases in compensation. If the move were general, the vicious spiral of cost and price increases would eventually put the whole structure on stilts, with the inevitable and disastrous fall.

Authoritative figures on hourly and weekly earnings and the cost of living indicate that labor is at no disadvantage in its earnings as compared with the other elements of the population, but rather the contrary. Indexes of the National Industrial Conference Board show that the average hourly wage rate in 25 manufacturing industries in September was 74.2 cents, the highest in the history of the country, and 26 per cent above 1929. Although the workweek has been reduced from an average of 48.3 hours in 1929 to 39 in September, the average

weekly wage in money was slightly higher than in 1929; and inasmuch as the cost of living was 15 per cent lower, the weekly wage commanded a purchasing power 19 per cent higher than in 1929.

If in the effort to extend these gains, the policy of labor leaders is to encourage demands to the point of contributing to an inflationary spiral, they will be doing what undoubtedly they will be quick to condemn if practiced by any other elements in industry.

The Fiscal Program

Further indication of the trend of Administration policy with respect to national defense financing has appeared in statements of Administration leaders this past month. In an interview with the press two days after the election, Secretary Morgenthau outlined three major proposals to be laid before Congress for early action. These proposals were (1) an increase in the federal debt limit to $60,000,000,000 or $65,000,000,000, (2) a further increase in taxes, and (3) elimination of the tax-exempt feature from future issues of both federal and local government securities. Following up Secretary Morgenthau's statement, Chairman Doughton of the House Ways and Means Committee predicted on November 20, after a conference with the President, that new taxes would be sought early in the next session of Congress sufficient to cover the "ordinary" expenditures of the Government and possibly leave something over to help defray defense costs.

Of the foregoing proposals regarding fiscal policy, that which was most startling to the general public was the proposal in regard to the debt limit. Not that a request for an increase was unexpected. With knowledge of the huge appropriations that have been made for national defense, public opinion was not unprepared for a request to raise the debt limit. It was the size of the increase asked for that has come as a shock. According to Secretary Morgenthau, the added borrowing power requested is expected to last only to June 30, 1942, a period of nineteen months, after which new requests for borrowing authority were plainly indicated.

Inasmuch as the federal debt now stands at approximately $44,200,000,000, it will be seen that what the Secretary is contemplating is deficit expenditures running to more than $15,000,000,000 to $20,000,000,000 during the next year and two-thirds. Aware though the public has been that the armament program would cost a great deal of money, such figures as these took the markets completely by surprise, reviving inflation fears and stimulating a burst of buying in stocks and commodities.

On the Question of Raising the Debt Limit

Is it either necessary or desirable that the debt limit be raised at this time to the full amount requested? A strong case for the negative was presented by Senator Harry F. Byrd, of Virginia, a frequent critic of Administration fiscal policies and a consistent advocate of economy in government. In a statement opposing the Secretary's request, Senator Byrd pointed out that only last June Congress raised the debt limit by $4,000,000,000 when it authorized the sale of that amount of additional securities for defense purposes in maturities up to five years. Not only this sum, but also some $800,000,000 of unused borrowing power under the old $45,000,000,000 debt limit, is still available to the Treasury. While it is true that the use of the added $4,000,000,000 is conditioned upon the purpose of the borrowing and the kinds of securities offered, these restrictions could be removed, thus giving the Secretary the same latitude in handling this debt that he has had in other debt operations.

Asserting that he would of course vote for whatever increase in the debt limit is necessary to finance defense expenditures, Senator Byrd argued against the increase proposed as unnecessarily large and hence as "an incentive for further extravagance in government."

"Under no circumstances," he said, "should it be necessary to raise the debt limit more than five billions at a time. The Congress should keep control of the statutory debt limitation by authorizing only such increases as are found to be necessary from time to time to meet the urgent needs of the Treasury."

Continuing, the Senator made some pointed remarks upon the subject of economy in non-defense spending which are worth repeating:

> In the face of gigantic expenditures for national defense universally approved by the nation, the Federal Government is still spending approximately the same huge amounts for strictly non-defense and non-essential peacetime activities of the government. Unless the country is to incur a debt of such magnitude as to menace seriously our financial security, the time has come to reduce non-essential non-defense spending to the absolute minimum, and devote consequent savings to financing the defense program, and no effort has been made yet for such reduction.
>
> Notwithstanding the terrific taxation now being paid by the American people, our Federal Government is not collecting enough to pay our strictly peacetime expenditures, after eliminating every dollar of disbursements for national defense. We should at once economize on non-essential peacetime spending.

The position taken by Senator Byrd seems both sound and reasonable. Like Senator Byrd, most good Americans are ready, undoubtedly, to vote whatever increase in the debt limit is necessary for national defense. There are, however, very real dangers in opening the gates too wide. Not only is it disturbing to public confidence, as evidenced by the inflationary outburst in the markets last month, but, as Senator Byrd points out, it tends inevitably to weaken the incentive to control unnecessary expenditures. There is a very real advantage in having the expenditure program come before Congress at periodic intervals for review and

debate. Nor can we see any possible disadvantage in this policy, since there can be no question of the willingness of Congress to go along on debt increases whenever the need for such action is clearly demonstrated.

It is unfortunately true that, rightly or wrongly, the impression created upon many by the magnitude of the Secretary's request with respect to the debt limit was that Washington was contemplating no serious effort to reduce non-defense spending. Certainly no estimates of the future debt requirements should be acceptable to the American people until clear evidence has been presented that everything possible has been done along these lines. When it is considered that non-defense expenditures are still running as high as in the depression years when the Government was carrying a heavy relief load and was in active pursuit of ways of spending money on the theory that this would promote recovery, it is difficult to believe that, with the huge expenditures for defense and with rising business activity generally, ways cannot be found for making substantial cuts in the non-defense budget, providing the will to do so exists.

It is encouraging, therefore, to have the President's recent statement of determination to cut non-defense expenditures "to the bone". Such economies of course will require support of Congress, business, agriculture, labor and the public at large. Not only is there a need for economy in the Federal Government, but even more so of a strict limitation of expenditures by state and local governments. With the growing burden of federal taxation, it is imperative for state and local governments to limit expenditures, particularly in long range projects which are costly to the taxpayers and may compete with the Federal Government in the markets for labor and materials. Many localities are now experiencing a reduction in relief costs, which instead of being turned to new expenditures should be applied toward reduction of existing taxes or debt. Public works should much better be saved against a possible post-war depression.

On the Question of Raising Taxes

The second question raised by Secretary Morgenthau, which is closely related to the debt limit, is that of a further increase in taxes. In his interview with the press, the Secretary suggested this need, and the recent statement by the Chairman of the House Ways and Means Committee, quoted above, indicates that the Government is continuing to press forward along this line.

On the proposition of raising taxes, however, like that of raising the debt limit, it would seem logical, despite the necessity for speed, to make sure that action is adapted to the real needs of the situation. It is of course desirable to pay as large a share as possible of the defense costs out of taxes. The point often overlooked, however, is that already within the past year we have had two major increases in federal tax rates, and raised them to extremely high levels, — higher even than at the peak during the last war. No one yet knows how much revenue these taxes will produce. Nor does anyone yet know the effects on the country's economy of these taxes. They will undoubtedly cause substantial readjustments in the character and channels of the country's expenditure of incomes, savings, etc. These and other changes now taking place in the economic structure should influence the form any new taxes should take.

While any attempt to forecast tax collections on the basis of estimated national income is necessarily hazardous, nevertheless certain calculations are of interest. In the President's budget message to Congress, submitted in January, 1939, an attempt was made to estimate tax collections at rates in effect in December, 1938, for three different levels of national income. According to this study a national income of $70,000,000,000 at the then existing rate of taxation might be expected to yield $6,000,000,000 in tax collections. With a rise in the national income to $80,000,000,000, tax collections were put at $8,000,000,000, while on a national income of $90,000,000,000 a tax yield of $10,600,000,000 was expected. These estimates included social security taxes, then treated in the budget as regular receipts, but since, in the case of old-age benefit taxes, treated as trust fund receipts. Since taxes are paid at varying intervals, there would of course be a time lag between any given level of national income and the tax collections expected from it.

The two revenue bills passed in 1940 were calculated to yield perhaps $2,000,000,000 annually, and if this were added to the estimates above, the result would be to lift the yield (including social security taxes) from a national income of $70,000,000,000 to $8,000,000,000, from a national income of $80,000,000,000 to $10,000,000,000, and from a national income of $90,000,000,000 to $12,600,000,000. At present the national income is estimated to be running at the rate of approximately $75,000,000,000 a year, and under the strong stimulus of the defense program may before long be running at the $80,000,000,000 rate.

It is doubtful that many people realize how productive the present high tax rates may prove to be during a period of high business activity. For the past ten years we have been raising taxes on an economy working far below maximum capacity, so that the true fruitfulness of these rates has never been tested. Indications are that once these rates begin to apply to a national income consistent with the coun-

try's potentialities, the results may prove to be truly astonishing.

In the following table is given a summary of United States Government receipts and expenditures for the fiscal year 1939 and 1940, together with the official estimates for 1941 submitted to Congress last January and revised in August; also a comparison of actual receipts and expenditures in the period July 1 to November 26 of this year and a year ago.

U. S. Government Receipts and Expenditures

(In Millions of Dollars)

Fiscal Year Ended June 30	Total Net Receipts	Defense Expenditures	Other Expenditures	Total Expenditures	Net Deficits
Actual					
1939	$5,165	$1,163	$7,544	$8,707	$3,542
1940	5,386	1,559	7,439	8,998	3,612
Estimated					
1941 Jan. Est.	6,248	1,840	6,584	8,424	2,176
1941 Aug. Est.	6,367	5,000	7,058	12,058	5,691
Actual					
1940 to Nov. 26	1,911	550	2,993	3,543	1,632
1941 to Nov. 26	2,132	1,199	2,691	3,890	1,758

Source: President's Budget Message and Treasury Statements. Excludes expenditures for net appropriations to old-age insurance trust funds and corresponding social security tax receipts; also excludes expenditures for debt retirement through sinking fund.

As indicated in the table, the revised estimates made public in August by Secretary Morgenthau indicated total expenditures for the current fiscal year of about $12,000,000,000, of which approximately $5,000,000,000 would be for defense, and approximately $7,000,000,000 for non-defense purposes. On this basis, the expenditures would be only $2,000,000,000 greater than the estimated yield of *current tax rates* on a national income of $80,000,000,000, and on a national income of $90,000,000,000 the budget would be balanced. Even though defense expenditures expand substantially, as they are certain to do, it ought to be possible with *the existing tax rates* when they become fully effective to cover total ordinary expenditures with a surplus of billions, which could be applied to defense expenditures and thus keep the total deficit within reasonable limits.

Of course, the foregoing calculations as to revenue yields are rough approximations, and are based upon certain assumptions as to the trend of national income and the relation of national income to tax collections. The purpose of presenting the figures has not been to make predictions, but to suggest possibilities. These possibilities make it seem clearly desirable not to burden the economy with another increase in taxes until we know more as to the yield from present taxes, and what kind of taxes are called for by the new situation.

Money and Banking

Notwithstanding fresh evidence daily of the enormous volume of business being generated by the defense program, it was the bond market rather than the stock market that experienced outstanding gains during the past month. Apart from a brief spurt following Secretary Morgenthau's proposal regarding the debt limit, referred to in the preceding article, the stock market has been generally dull with a sagging tendency, investors apparently taking a disparaging view of company share prospects in the face of war uncertainties and fears as to the effect of rising taxes and other costs upon earnings.

High grade bonds, on the other hand, commenced to move forward immediately after the election, on buying widely attributed to a belief that the election results increased the likelihood of continued easy money policies. Then came the Morgenthau statement just mentioned. Ignoring completely the proposed increase in the debt limit and all that such an increase might imply, government and municipal securities reacted strongly to the suggestion of doing away with future issues of tax exempt securities, especially since this suggestion was accompanied by the advocacy of higher taxes on corporate and individual incomes. Within a few days Treasury issues jumped ½ to over 2 points, depending upon maturities, going through the old highs reached in the Summer of 1939 with a rush. Municipals were equally buoyant; in the first week after election long-term New York City bonds made gains averaging 3¼ points and New York Port Authority bonds about 2 points. While these two were among the most spectacular performers in this class of securities, price rises throughout the municipal list led to an average yield reduction of about 0.15 per cent.

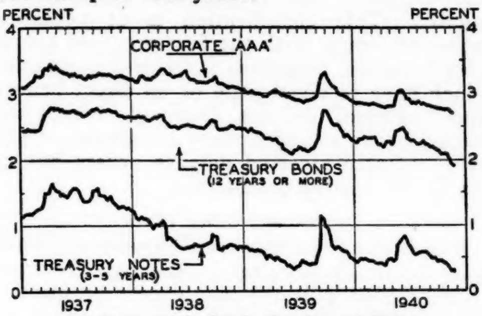
Following this initial burst of strength, the market quieted down and prices sagged off somewhat from the peaks. Later in the month buying of "governments" again became strong, carrying most of the issues through the previous highs. Actively traded municipals, on the other hand, gave up about half the post-election gains. Accounting for bearishness in the latter group was a sudden and substantial increase in the supply of new issues seeking a market, stimulated in part undoubtedly by fears of state and municipal officials of possible legislation barring future tax-exempt issues.

While trading in high grade corporates lacked the sensational features of the trading in governments and municipals, prices generally moved forward on a broad front, many issues reaching new highs. Lower grade corporates — especially in the rail group — whose credit rating has been improved by better business conditions, have advanced substantially

in recent months, while purely speculative issues have fluctuated with the stock market.

What Has Been Happening to Interest Rates

The accompanying diagram gives some idea of what has been happening to interest rates over the past four years.



Yield on High Grade Bonds and Notes

It will be seen that the average yield of AAA corporation bonds, according to Moody's, is now about 2¾ per cent. Individually, however, numerous issues are yielding much less. In the Moody index, the industrial bond yield component is down nearly to 2¼ per cent, and even this low yield seems generous when matched against what prime railroad equipment trust certificates are affording. For example, $10,000,000 Atchison Railway serial 1 - 10-year equipments sold last month at rates varying from 0.20 to 1.50 per cent, which for the later maturities was lower than the equivalent taxable yield on governments despite the latters' premier credit rating.

For the investor in government bonds, the average yield on issues longer than twelve years is now under 2 per cent for the first time, with the longest issue — the 2¾'s of 1960-65— yielding only about 2.10 per cent. Certainly this seems small compensation for the risk of market fluctuations, to say nothing of possible changes in the purchasing power of the dollar over so long a period. Yet this price level for long bonds is not unique in the market, as witness a recent issue of State of Connecticut serial obligations at yields to the purchaser ranging from 0.50 per cent for the first maturity, in 1944, to 1.52 per cent for the last maturity, in 1971. The lower yield on the state issue, of course, reflects its complete exemption from income taxes.

Turning to the short-term money market, a situation equally, if not more, difficult will be found facing lenders and investors. With a lack of normal outlets for funds in industry and trade, unemployed money has crowded in increasing volume into the short-term government market, reducing rates literally to the vanishing point. For a long time past the Treasury's weekly 90-day discount bill offerings have sold practically at par, while in the Treasury note market all maturities through December, 1942, are now quoted above a no-yield basis, investors being willing to hold them in hopes of conversion privileges. Even the longest issue of notes—the ¾s of March, 1945—yield less than ½ of 1 per cent.

Interest Rates and Credit Policy

The question is, where is all this leading us? Repeatedly, during the course of the long bull market in bonds, many investors have come to the conclusion that bond prices were high enough and due for a turn, only to see them go higher. When the war broke out in September, 1939, the conviction became widespread that at last the long rise of bond prices and decline of interest rates had come to an end; and prices fell sharply as frightened investors hastened to unload while there was still time. But now bond prices are higher, and interest rates lower, then ever.

The fact is that the decline in interest rates has already gone much farther than is good for the country and is paving the way for serious difficulties in the future. Experience has shown that excessively cheap money in the long run stimulates unwise expansion of credit, which leads to price inflation and affects the soundness of the financial structure. The current low rates of the past few years have exacted a heavy penalty from institutions and individuals dependent upon strictly investment income, and have induced many who can ill afford to take risks to place their funds in higher-yielding, though more speculative, securities. Similarly, they have forced banks in the search for earnings into the purchase of high-priced bonds and involved the security of the banking system as never before in the future course of interest rates. Current low rates also hamper the placement of bonds outside of the banking system, and thus may become a serious obstacle in sound defense financing, which as the program develops should depend upon an increasing sale of government securities to non-banking holders if inflation is to be avoided.

All this serves to emphasize the need for checking the bull market in bonds before prices are driven to still more dangerous heights and yields to still more narrow margins. The Federal Reserve authorities have given evidence of an awareness of these dangers in their policy of selling government securities from time to time during the past year in periods of rising prices. The recent rise in the market, however, raises the serious question as to whether supplementary and stronger action may not be desirable to prevent the further expansion of the excess reserves of the banks, and perhaps even to reduce the excess reserves, which are a primary cause of the pressure of idle money which is lifting bond prices and diminishing interest rates.

Corporation Earnings and Taxes

Since our summary was given last month of the net profits of 350 leading industrial corporations for the third quarter and the first nine months, many additional reports have been issued and emphasize the uneven changes among different major industries. Most companies having a large increase in volume of sales due to English purchases and to our own national defense program reported a sharp increase in net profits, despite larger reserves against income and excess profits taxes. Special factors improved profits in certain other lines, including pulp and paper, petroleum and coal mining. In most lines which received little direct benefit from defense expenditures, however, the increased taxes caused large numbers of companies to show lower net profits than a year ago.

This reversal of trend may be seen from the following summary, classified according to these two groups, which shows the combined dollar profits after taxes and less deficits of 540 leading industrial companies in the third quarter and first nine months of 1940, and the percentage change from the same periods of 1939:

Net Profits after Taxes of Leading Industrial Corporations for the Third Quarter and First Nine Months of 1940, with Percentage Changes from 1939

(In Thousands of Dollars)

No.	Industrial Groups	Third Quarter	Per Cent Change	Nine Months	Per Cent Change
	Directly affected by war and defense program				
16	Textiles and apparel	$5,024	+33.5	$16,005	+48.3
12	Wood products	1,480	+71.3	3,369	+ a
23	Paper products (b)	11,494	+ a	34,224	+ a
26	Chemical products	42,569	— 0.1	138,612	+20.6
35	Iron and steel	77,269	+ a	172,650	+ a
13	Building equipment	6,358	+34.2	13,950	+ a
17	Electrical equipment	20,666	+38.9	68,870	+56.8
35	Machinery	8,685	+30.2	25,529	+78.6
13	Railway equipment	7,470	+58.1	23,267	+ a
28	Auto equipment	5,982	+27.7	32,306	+50.7
8	Aircraft and parts	12,108	+62.0	37,234	+76.1
35	Metal products—misc.	8,835	+19.6	29,106	+53.6
23	Metal mining	16,026*	+ 2.8	51,080*	+49.8
284	Sub-total	223,966	+49.7	646,202	+79.2
	Affected only indirectly by war and defense program				
11	Baking	4,815	—16.2	13,952	—15.4
26	Food products—misc.	19,909	—18.9	62,418	— 3.2
8	Beverages	8,151	—30.6	26,746	— 7.6
14	Drugs, soap, etc.	12,334	—18.7	43,386	— 4.0
23	Petroleum products (b)	31,162	— 9.6	115,012	+64.8
24	Stone, clay and glass	11,943	— 3.3	31,704	+16.5
12	Household equipment	1,980	+11.9	5,479	+14.9
10	Office equipment	4,001	+ 0.8	15,244	+21.3
13	Automobiles	15,640	+23.7	162,044	+17.8
31	Misc. manufacturing	5,330	+16.8	16,969	+26.6
13	Coal mining (b)	661*	+ a	1,354*	+ a
25	Misc. mining, quarrying	5,958*	+25.7	18,674*	+18.6
25	Trade (whol. & retail)	9,684	—24.6	28,807	— 2.8
21	Service, amuse., constr.	2,633	+60.9	10,420	—12.3
256	Sub-total	134,201	— 7.2	552,209	+16.3
540	Total	$358,167	+21.7	$1,198,411	+43.8

a—Increase of more than 100 per cent not computed. b—Profits affected by special factors also. *Before certain charges.

It will be seen that the 284 companies in the first group had a combined gain over last year of approximately 50 per cent for the third quarter, and 79 per cent for the nine months, but that the 256 companies in the second group had a decline of 7 per cent for the third quarter and a gain of but 17 per cent for the nine months. This classification is of necessity rather arbitrary, with the first group of industries including numerous individual companies which have received little or no direct benefit from national defense business, while the second group includes many companies which have recently received defense orders but as yet hardly started production.

Income and Other Taxes

The increase in corporate income tax rates from 18 to 24 per cent in the two Revenue Acts of 1940, plus the new excess profits tax running up to 50 per cent, caused a sharp increase this year in the amount of such taxes payable and absorbed a substantial portion of whatever increase occurred in earnings. This was particularly true in the third quarter, when additional reserves were necessary because of the new rates being made retroactive to the first of the year.

On most of the interim statements issued by corporations, the only tax details — if any — given are for federal income and excess profits taxes. Figures as to the sum-total of taxes, however, including state, local and miscellaneous federal, are usually given in the more detailed annual reports to shareholders and to the Securities and Exchange Commission.

Below is a tabulation from these sources for the year 1939 of fifty nationally-known companies, each the largest, or one of the largest, in fifty different lines of manufacturing, mining

Taxes	
Income taxes	$186,221,000
Other taxes	699,316,000
Total federal, state and local	$885,537,000
Sales or Gross Income	
Total	$10,101,609,000
Taxes to sales or gross income	8.8%
Net Income	
Total before taxes	$1,661,889,000
Taxes to net income before tax	53.3%
Total after taxes	$776,352,000
Taxes to net income after tax	114.1%
Net Worth	
Total January 1, 1939	$9,986,684,000
Taxes to net worth	8.9%
Net income after tax to net worth	7.8%
Dividends to net worth	5.8%
Dividends	
Total cash dividends	$577,820,000
Taxes to dividends	153.2%
Shareholders	
Total number	2,810,582
Dividends per shareholder	$206
Taxes per shareholder	$315
Employes	
Total number	1,603,332
Taxes per employe	$552

and trade, as well as transportation, electric power and communication, showing the relationship of total taxes (including excise taxes) to other significant items for the group.

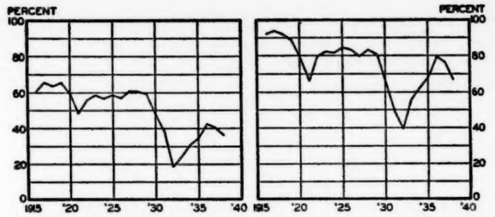
For most companies, the taxes based upon net income comprise only a minor portion of the total, while the major portion is made up of property taxes, social security taxes, unemployment taxes, excise taxes, franchise taxes, capital stock taxes and others, which are payable regardless of the amount of net income. Detailed figures of taxes paid last year by the fifty large companies reveal that income taxes (including state and foreign, as well as federal) of the group aggregated $186,000,000, or 21 per cent of the total, while "other taxes" aggregated $699,000,000, or 79 per cent.

Earnings of All Corporations

Recently the Treasury Department released preliminary statistics on the income of all corporations in the United States for the year 1938. As has been pointed out heretofore, the promptly published reports of leading corporations are useful as indicating profits trends, but the only measure of average earnings for business as a whole is to be found in the official statistics.

Returns for 1938 were filed by 520,500 corporations, of which 169,885 reported having net income, 301,146 had no net income, and 49,469 were inactive. Excluding the latter, about 36 per cent of all active corporations operated at a profit, while the remaining 64 per cent had deficits.

The percentage reporting net income in 1938 was the lowest for any year, except for the period 1932-1935, since the compilation of official statistics was begun in 1916. Comparison of the figures by volume of business handled reveals a more favorable showing as to the percentage in the black, though with a trend which is likewise downward. In 1938, com-



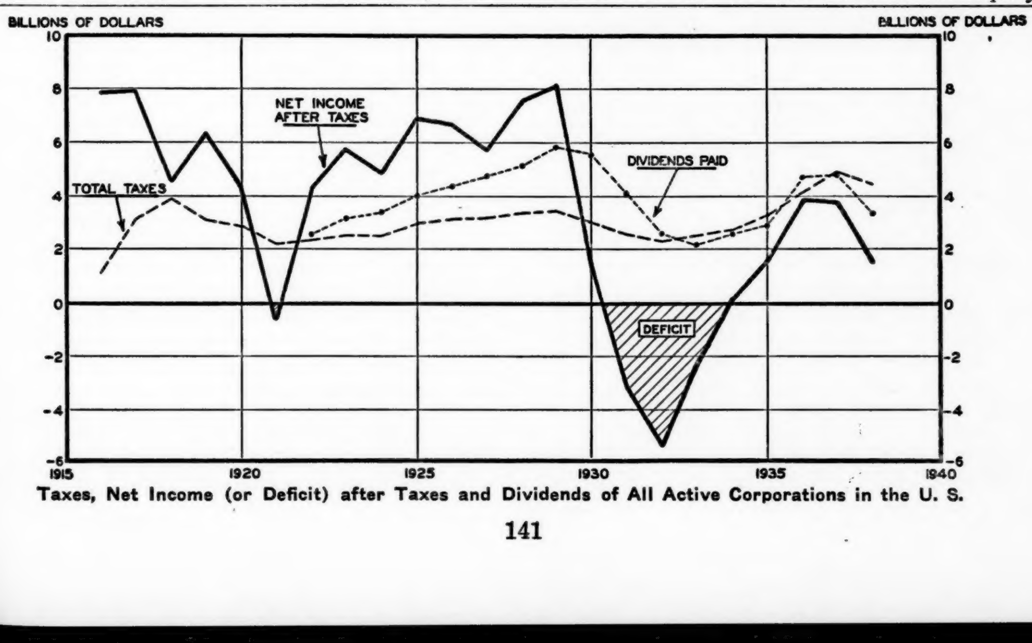
% of All Active Corporations in the U. S. Having Net Income   % of Gross Business Handled by Corps. Having Net Income

panies with net income had approximately 67 per cent of the sales and other income of all corporations; approximately one-third of the total corporate business was reported done at a loss.

The total of corporate taxes paid, net income after taxes and dividends paid, as reported from the same source, are shown on the next chart. The preliminary figures for 1938 indicate that combined net income, less deficits and after taxes (with allowance for the exclusion of intercorporate dividends and the addition of wholly tax-exempt interest received) amounted to approximately $1,500,000,000.

This is about 60 per cent below the $3,900,000,000 totals of 1936 and 1937, and is 80 per cent or more below the totals of $7,500,000,000 in 1928 and $8,000,000,000 in 1929. Moreover, the average level of earnings over the past decade has been lowered by the heavy deficits during 1931-1933 and the depletion of capital from which large numbers of corporations (including railroads) have never recovered.

Complete official statistics as to the sum-total of taxes paid in 1938 are not yet available, but final figures for 1937 show that taxes paid by all corporations in that relatively good year exceeded the total corporate net income after taxes, and exceeded the total of dividends (excluding intercorporate) paid to the shareholders for the use and risk of the equity



Taxes, Net Income (or Deficit) after Taxes and Dividends of All Active Corporations in the U. S.

capital investment in American business. Even the reported total of taxes paid is an understatement, since it does not include such taxes as have been charged to "cost of goods sold" or "cost of operations" in the returns. Nor does it include sales or excise taxes for which the corporations act merely as collecting agents; nor the taxes levied upon the recipients of corporate wages, salaries, interest and dividends; nor the taxes represented in the cost of materials, rent, insurance, transportation, public utility and other services purchased by the corporations.

Finally, an indirect tax cost which cannot be overlooked is the cost of preparing and filing the returns themselves, including the greatly expanded records and labor now needed for collecting tax data. Large organizations must file from several hundred to several thousand separate tax returns of one sort or another each year, and have whole departments devoted to this work. For the small company, firm or individual proprietor, the burden may be even more serious, relatively, in that the executive head of the business must spend considerable time on tax matters which otherwise could be applied to production and selling.

Although the burden of corporate taxes affects in varying degree the consumers, employes and shareholders of corporations, and, speaking generally, is borne in the last analysis by the general public, the immediate effect of steeply increased taxes upon corporations operating on a narrow margin of profit is to cut this margin or turn it into a loss.

An examination of the government statistics on corporate income affords striking proof that our so-called "profit system" is really a "profit-and-loss system". Taxes have become one of the major costs in production and distribution and consequently must be given careful consideration by business men and investors, who naturally are reluctant to expand facilities unless there seems a reasonable chance of making a fair return on the new capital to be invested, rather than a loss.

British War Taxes and Corporate Earnings

In considering the outlook for corporate earnings in this country under present taxation, the experience of British corporations since war taxes were imposed is worth examination. Corporate tax schedules in Great Britain have been raised during the past year to levels considerably higher than the new rates set in the United States, and some practical examples of their effects are now available from recently published reports.

Compared with our normal corporate income tax rate of 24 per cent, the British standard rate, enacted in the second supplementary war budget last July, is now 42½ per cent. From the outbreak of the war to April it was 37½ per cent, and in the year before the war 27½. In order to raise funds for rearmament, a 5 per cent tax called a "national defense contribution" has also been levied on profits since 1937. This defense tax has now been made an alternative to the excess profits tax imposed in September 1939 by the first supplementary war budget. The taxpayer calculates both his excess profits tax and his defense contribution, and pays whichever is higher. Thus the defense contribution falls on business which has little or no war profit.

The British excess profits tax applies to all enterprises earning over £1,000 per year. As originally enacted, the rate on profits in excess of "standard" earnings was 60 per cent. In the second supplementary war budget the rate was raised to 100 per cent. Standard profits are those earned from trading operations (but excluding investment income) during one of several base periods chosen at the option of the taxpayer. For companies established before 1935, the base period may be 1935, or 1936, or the average of 1935 and 1937, or the average of 1936 and 1937, all of which were fairly active and prosperous years in Great Britain. In special cases, where a company was developing or was in a depressed state during the base years, the Board of Referees set up by the Act may increase the base period earnings to cover fixed charges and dividends on preferred stock plus 6 per cent on common stock. With the standard profits established, the British Treasury collects 100 per cent of any excess profits, computed before income tax, but with deduction of debenture interest permitted. The normal income tax is then payable on the remainder of the earnings.

These British Treasury taxes correspond with our U. S. Treasury income and excess profits taxes, and are not comparable with the sum-total of taxes paid by American corporations as described in the preceding article.

British Company Earnings

Ordinarily, the lack of uniform accounting practices by British corporations in charging income taxes makes comparisons of statements difficult. In some cases, only the company's tax is shown as a deduction, while in other cases the tax on shareholders' dividends is also given by the company. To make the figures uniform and to show the full impact of taxation, the London Economist publishes compilations of corporate earnings in which all statements are adjusted to include the tax on dividends.

A compilation of these adjusted company results shows that in the three month period ending November 2, 1940, the "total profits" before taxes, consisting of trading profits and other income of revenue nature, of 337 companies aggregated £50,345,000 or about 5 per cent more than in the same period last year,

when they were £47,914,000. Deductions from this income, including taxes and other charges such as debenture interest, increased about 36 per cent over last year, from £21,832,000 to £29,778,000, and the increase probably was caused almost entirely by higher taxes. The net profits after taxes were £20,567,000, or down 21 per cent from last year, when they were £26,082,000. These corporate reports do not show as yet the full effect of the 100 per cent excess profits tax, for the rate in the period covered was only 60 per cent. Moreover, the Economist's tables of company returns in the last three months still include companies whose accounting year ended in December 1939 to March 1940, as well as companies which operated outside of Great Britain in the Empire.

Effects of Taxation

Generally speaking, the increased taxation has been least burdensome on the companies which were the more efficient producers, whose nationwide business benefitted by the increased spending power, or whose profits were relatively high during the base years. In the case of one of the largest breweries, whose earnings have been relatively high in the last few years, the Government's share of profits during the fiscal year ending June 30 last increased to about 52 per cent, compared with 36 per cent a year ago. The net, however, was well-maintained. The new taxes fell heavily on companies engaged on war orders. One company, a leader in alloy and welding, increased the amount set aside for taxation for the year ended last June by about 200 per cent as compared with year ago. Its total trading profits rose by 55 per cent in the same period, however, and its net after taxes was off only slightly. The statement of another corporation, one of the largest and most efficient steel producers in Great Britain, shows that its taxes almost trebled in the past fiscal year and now absorb nearly 70 per cent of total earnings, compared with but 22 per cent last year. In this case, the net after taxes was down 22 per cent.

The burden of taxes and particularly of the excess profits tax, has been felt most seriously of all (despite the relief permitted by law for unusual cases) by the newer corporations or those, as the Economist points out, whose profits were unduly low during the base years because of business conditions in their industry or of corporate reorganization. In the case of one of the recently developed aircraft companies, the Treasury took about 91 per cent of total profits for the year ended March, and the shareholders received only 9 per cent. Another aircraft company, which increased its capital by 170 per cent during the past year, shows that its net profits, after taxes, rose by only 10 per cent. Still another, a company making aircraft parts, shows that its taxes increased about five-fold and are actually higher than its entire issued capital. As a result, its net earnings after taxes, declined to one-fifth those of a year ago.

Canadian Experience

In Canada, the Dominion normal income tax rate applicable to corporations is 18 per cent (20 per cent on consolidated returns). The modified excess profits tax, as enacted in the second Canadian war budget last July, provides either for an additional levy of 12 per cent on the total net profits or a levy of 75 per cent on excess profits over a base period whichever is greater. Hence, the income tax minimum becomes 30 per cent regardless of whether or not a corporation has an excess of profits over the standard period. In addition, various provincial governments and municipalities levy special business taxes.

The revision of the excess profits tax law in July raised the tax rate from 50 to 75 per cent. It also required the use of 1936-39 average earnings as the base for calculating the excess, and removed the former alternative of a graduated tax on invested capital. In Canada, however, as in Great Britain, the Board of Referees may impose a capital standard, where capitalization is unusually small or earnings were subnormally low during the base years. In contrast with Great Britain, the Canadian excess profits tax is calculated *after* deduction of the normal income tax. Its present provisions are retroactive to January 1, 1940.

Reflecting the expansion in volume of business this year, the statements of Canadian companies, especially those engaged in mining and industries working on war orders, show considerable increases in net operating income. Because of the new taxes, however, net earnings after taxes show in most cases little if any gains over last year. International Nickel Company of Canada, Ltd., for the first nine months had an increase of 19 per cent in net operating profit over that of last year, but due chiefly to a rise of 110 per cent in income and franchise taxes, the net profit before dividends declined by about one per cent. The statement of one of the large utility companies shows a quadrupling of tax levies during the second quarter, and a drop in net profit available for dividends of about 10 per cent.

The situation is reflected also in the course of dividend payments by Canadian companies. The dividend index of 47 industrial enterprises prepared by Nesbitt, Thomson & Co. Ltd. of Montreal shows for the first ten months a decline of 8 per cent as compared with last year, while the dividend tabulation by the Financial Post of Toronto of all publicly announced declarations shows for the same period an increase of about 5 per cent. This despite the fact that Canadian industrial production has been nearly 25 per cent higher this year than in 1939.

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